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No.'s 278-282

JOINT REPLY BRIEF FOR PETITIONERS

IN THE

Supreme Court of the United States

October Term, 1945

RECONSTRUCTION FINANCE CORPORATION, INSURANCE GROUP COMMITTEE, GUARANTY TRUST COMPANY OF NEW YORK, TRUSTEE, CENTRAL HANOVER BANK AND TRUST COMPANY, TRUSTEE, UNITED STATES TRUST COMPANY OF NEW YORK, TRUSTEE, and THE CHASE NATIONAL BANK OF THE CITY OF NEW YORK, TRUSTEE,

Petitioners,

vs.

THE DENVER AND RIO GRANDE WESTERN RAILROAD COMPANY, ET AL.,

Respondents.

ON WRITS OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE TENTH CIRCUIT

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March 1, 1946.

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INTRODUCTION

The briefs for the Respondents merit no extended reply. Confining our attention to the essential issues, we leave unmentioned many auxiliary contentions, however unfounded, even the reiterated contention that prior compromise proposals of the parties themselves have the effect of admissions and that admissions establish a standard of reasonableness limiting administrative action. That contention sufficiently answers itself.

The essential issues are adequately put in our Opening Brief. We comment here only on certain points of fact that may be confused by statements in Respondents' briefs and on certain issues they seek to raise beyond those actually presented. These have to do with the state of the record (dealt with in 1 below), the history of earnings (dealt with in 2 below) and the Debtor's excursions into other fields (dealt with in 3 below).

1.
THE RECORD

The record was not closed in 1941, as the Debtor asserts (pp. 9 and 17). The last hearing before the Commission was at that time.* But while the case was under submission to the Commission, it received further evidence from the District Court taken at a hearing in October, 1942, dealing with the earnings, cash resources and cash requirements of the road (R. 981-1028). Both the Debtor and the General Mortgage Trustee were represented at this hearing (R. 981). In the course of it there were described the new sources of traffic developed in wartime and the revenue expected from them (R. 995-6 and 1016-17). It is significant that the Geneva steel plant was one of the principal new

*See our Opening Brief, p. 13.

installations described (R. 995), though said by the Debtor to have been "constructed after the formulation of the Plan" (Brief, pp. 25 and 38).

The current course of the affairs of the road was still later shown in evidence at a hearing before the District Court in April, 1943 (R. 1028-45). The Debtor and the General Mortgage Trustee were again represented. Among other matters, the evidence showed the earnings for the full year 1942 and the first three months of 1943, the current asset position and the trend of wages and taxes.

By direction of the District Court, the transcripts of both hearings were certified to the Commission. They were received by the Commission, considered by it in its "formulation of the Plan" and referred to in its report of June 14, 1943, approving the Plan (R. 142-3). In addition, by stipulation of all the parties, current financial statements and other material filed with the District Court were always before the Commission as a part of its record (R. 661, 789, 879).

Clearly, therefore, the Commission's record was a modern one and portrayed the current situation down to a date within sixty days of the time it approved the Plan.

The Debtor's objection against denial of its motion of May 1, 1943, for a rehearing before the Commission (Debtor's Brief, pp. 17-22) is not among the issues in the cases at bar, but is only among the potential issues under the Debtor's petition for certiorari, which has not been granted. Not only that, but, in the light of the above circumstances, it is plainly without substance. There was no reason for the Commission to have a further hearing, and its refusal to have one was a matter wholly within its unreviewable discretion (*I.C.C.* v. *Jersey City*, 322 U. S. 503 (1944)). In that case the Court so held in a rate case when public authorities asked a rehearing before the Commission, not merely for further argument (as the Debtor says, p. 21), but "'in

order that the said record be brought up to date' " so as to show the results of war-time earnings (322 U. S. at p. 509). In so holding the Court pointed out that *Atchison T. & S. F. R.* v. *U. S.*, 284 U. S. 248 (1932), relied on by two of the Respondents,* had been "promptly restricted . . . to its special facts" (322 U. S. at 515).

While on the subject of the record, we wish also to correct the statement of the Debtor (p. 26), made as one of fact, but actually a conclusion, and an erroneous one at that, with regard to the Utah Fuel stock. In our Opening Brief we pointed out that nothing in the agreement of 1924 (R. 1080) creating certain junior claims on the Utah Fuel stock for the benefit of the R&I Mortgage and the General Mortgage, in that order of priority, did, or could, in any way affect or vary the rights of the Western Consolidated Bonds through their first lien on that stock created many years before (Opening Brief, pp. 99-100). The privilege conferred by the 1924 agreement to proceed, upon foreclosure, against the Utah Fuel stock before proceeding against the fixed properties of the railroad was not, as the Debtor says (Brief p. 26), a requirement that such action "must" be taken, and had no relation whatever to the Western Consolidated Mortgage, whose rights are controlling upon review of the Plan. It is, therefore, irrelevant to the issue.

2.

EARNINGS

The Respondents emphasize the contention that the General Mortgage Bonds have, by impounding, a lien on earnings since the beginning of the trusteeship in an amount greater than their award of new Common Stock,** imply-

*Debtor's Brief, pp. 20-21 and MOP Brief, pp. 18-19.

**General Mortgage Trustee's Brief, pp. 16, 18, 44-45; Debtor's Brief, p. 22.

ing, perhaps, that the right to the income impounded thereby vested in favor of the holders of the General Mortgage Bonds. But all of the prior lien mortgage trustees, on behalf of senior lienholders, took substantially simultaneous steps to impound income with regard to each item of property on which the General Mortgage is a lien. Thus no income could be impounded for the benefit of the holders of the General Mortgage Bonds unless the Prior Lien debts were paid in full.

In fact, on the Respondents' own figures, there was a deficit after *interest alone* on senior bonds in every year of the trusteeship until the unprecedented war year of 1942, indeed a deficit that exceeded 16 million dollars. A unique combination of favorable circumstances in the next year (the extraordinary volume of traffic, the relatively lower level in the rising spiral of operating costs and the tax carry-over of earlier deficits) largely reduced this accumulated deficit by the end of 1942, though it still exceeded 3 million dollars. It is only if earnings after the effective date of the Plan on January 1, 1943, be taken into account that this deficit disappears. But that is precisely what the General Mortgage Trustee may not do. It is not entitled to special equitable recognition because of earnings after the stated effective date of the Plan, for if the Plan be otherwise within the powers of the Commission and the District Court, all these earnings equitably belong to the recipients of the new securities. In addition, of course, the Senior Claims have a first lien on those earnings not only for their accrued unpaid interest, but also for their matured principal, in an aggregate amount far exceeding the total earnings (our Opening Brief, pp. 66-67).

On the fundamental point of prospective earning capacity as illustrated by the record of operations in the past the General Mortgage Trustee presents a table of earnings that

is confusing (Brief p. 21). It is important that the defects in that table be recognized.

(*i*) The question under review is the validity of the Commission's action in limiting the total new securities to the amount provided for in the Plan. The relevance of past earnings, taken as one of the indications of earning capacity for the future, is the extent to which they are adequate, or inadequate, to provide a fair return on the new securities provided for in the Plan. That can be shown only by a comparison of those earnings with the amounts required for that purpose, as shown in Appendix F to our Opening Brief. It can not be shown by a comparison of past earnings with anything else, particularly with the amounts required for interest on the excessive debt capitalization of the past which the property has demonstrated its inability to support. Yet that is the only purpose of the General Mortgage Trustee's table and the only information that can be derived from it.

(*ii*) In order to reach a result favorable to its contentions, the General Mortgage Trustee extends the period of the study into the past beyond the termination of Federal control after World War I, though such prior years involved conditions so essentially different as to afford no guide to the expectable future. For one thing, the record shows that the Rio Grande was then predominantly an originating carrier, while now it is predominantly an overhead carrier (our Opening Brief, p. 5). It is well known that the rate structure in those days was entirely different from that of modern times, the competition of trucks, buses and private automobiles had not developed to modern proportions, passenger revenues were at levels never subsequently approached until the abnormal and non-recurring conditions of World War II, and operating expenses for maintenance during government operation were notoriously, though necessarily, inadequate. Over half the total earnings which

would appear from this table to have been available for interest on the General Mortgage Bonds in the past are derived from these years before 1921. The table is not informative until those years are excluded, as is done in Appendix F to our Opening Brief.

(*iii*) The General Mortgage Trustee's table wholly fails to make any provision for accrued unpaid interest on bonds admittedly senior to it in lien, but takes into account only the principal of those bonds. The amount of the unpaid interest on senior bonds at the stated effective date of the Plan on January 1, 1943 was 35 million dollars (Appendix D to our Opening Brief). This sum is so large that no table omitting it can be informative. Provision for this sum is made in the Plan and reflected in Appendix F to our Opening Brief.

(*iv*) The General Mortgage Trustee's table fails to make any significant provision for Federal income taxes, though earnings for the future will surely be subject to a heavy toll for that public purpose, not only because of the tax rates that will obtain but also because of the conversion, required by the public interest, of much of the old debt into stock.

With such infirmities, the General Mortgage Trustee's table is wholly uninformative.

None of these objections can be urged against our portrayal of the facts in Appendix F to our Opening Brief. Nor is it true, as the General Mortgage Trustee urges (p. 20), that our table depends on any hypothetical factors or assumptions. The only assumption it makes it that the Plan was in effect during the period under review, and that is a necessary assumption because the whole purpose of the table is to see to what extent the property could have supported the Plan in the past. Our assumption of a 35 per cent income tax

rate as illustrative of future possibilities is in no sense a condition to the validity of the table, for the table also shows that even without any Federal income taxes whatever, past earnings would not have been adequate to supply a fair return on the new securities already provided for in the Plan. The only significant adjustment we made in reported earnings was to increase them by about 9 million dollars in order to make up for what seemed a manifest understatement of earnings in 1936-39 due to the active prosecution of the improvement program in those years (Note 2 to Appendix F). But we made that adjustment only to show the case most favorably to the General Mortgage Trustee and willingly relinquish it, if desired, and thus increase the resulting deficit by the same figure of 9 million dollars.

Thus it is clear, we believe, that past earnings, under any realistic analysis, have been seriously inadequate to provide a fair return on the new securities already provided for in the Plan, and on that ground alone we submit there necessarily was evidence to support the Commission's determination of permissible new capitalization.

The menace of rising costs of operation for the future, a rise that seemed to us, on the record of many years, inexorable, is muffled by the General Mortgage Trustee under general reference to operating ratios of Class I railways (Brief, p. 22). This is a superficial suggestion. Of course operating ratios, representing the relation of total operating expenses (exclusive of taxes) to total operating revenues, fluctuate with the volume and type of total business. A railroad not operating at capacity can obviously carry additional business at a cheaper unit cost. This is true specifically of the Rio Grande. As Trustee Swan testified in 1942,

> ". . . . the higher the level of traffic the bigger the recovery on the additional business" (R. 1017).

This increase in profit, and resulting decline in operating ratio, is accentuated where the additional business, as is well known to have been the fact in recent war years, is in manufactured goods carrying higher rates, such as airplane engines, military equipment, chemicals, explosives, etc. It is all the more ominous that, in the face of such circumstances, the operating ratio of the Rio Grande increased from 57.4 in 1942 to 65.5 in 1943, though gross revenues were 16 million dollars greater,* and increased from 65.5 in 1943 to 70.7 in 1944 while total operating revenues remained substantially unchanged.** These trends confirm the liberality of the Commission's Plan.

3.

THE DEBTOR'S EXCURSIONS

We think there is no need here to follow the Debtor's excursions into the position of the stockholders in this case,† for the Debtor's petition for certiorari on those issues has not been granted, and we have no doubt the Court will allow a proper opportunity for briefs and argument were it ever to be allowed and the resulting issues presented. There is, of course, still less reason to pursue the Debtor's discussion of the position of stockholders in fourteen other railroad reorganizations, for they have never at any time been at issue in these cases. We think it sufficient here to record our disagreement with the views there urged. Since special emphasis is laid on the contention that interest should not be allowed at contract rates during the course of reorganiza-

*1943 Annual Report, pp. 11 and 19.

**"Income Account, Statement of Revenues, etc. for December 1944".

†Debtor's Brief, pp. 16-50 and Appendix A thereto.

tion, we might add that the contrary has been immemorially established, both as a "fixed principle" of reorganizations in equity,* and as to the rights of a secured creditor against his security in bankruptcy.** It has rightly been established also, by successive decisions of this Court, as a governing rule under the corporate reorganization laws, both in the case of industrials† and in the case of railroads.††

CONCLUSION

We respectfully submit that the orders of the Circuit Court should be reversed in their entirety, with instructions

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*American Iron and Steel Manufacturing Co. v. Seaboard Air Line R., 233 U. S. 261, 266-7 (1914); Ticonic National Bank v. Sprague, 303 U. S. 406, 412, 413 (1938).

**See *Louisville Joint Stock Land Bank v. Radford*, 295 U. S. 555, 597, n. 30 (1935); *Ticonic National Bank v. Sprague*, in next preceding footnote, and cases there cited.

†*Consolidated Rock Products Co. v. DuBois*, 312 U. S. 510, 527 (1941).

††*Group of Institutional Investors v. Chicago, Milwaukee, St. Paul & Pacific R.*, 318 U. S. 523, 546 (1943); see *Ecker v. Western Pacific R. Corp.*, 318 U. S. 448, 509-10 (1943).

to affirm the orders of the District Court approving and confirming the Plan.

Dated March 1, 1946.

Respectfully submitted,

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